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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 319

314 U.S.
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BEAR GULCH WATER COMPANY,
a corporation,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI

To the United States Circuit Court of Appeals
For the Ninth Circuit

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To the Honorable Harlan Fiske Stone, Chief Justice of the United States, and the Associate Justices of the Supreme Court of the United States:

Your petitioner, BEAR GULCH WATER COMPANY, a corporation, respectfully prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit (R. 68), entered in the above entitled cause affirming a

decision of the United States Board of Tax Appeals (R. 31).

OPINIONS BELOW.

The opinion of the United States Circuit Court of Appeals (R. 62) is reported in 116 Fed. (2nd) 975.

The opinion of the United States Board of Tax Appeals (R. 19) is reported in 40 B.T.A. 1281.

JURISDICTION

Judgment of the Circuit Court of Appeals was entered January 13, 1941 (R. 68). Petition for rehearing filed February 20, 1941 was denied on May 1, 1941 (R. 69). The jurisdiction of this Court is invoked under 28 U.S.C.A., Section 347 (Judicial Code, Section 240, as amended).

STATUTES INVOLVED.

The statutes involved are: Section 103(6) of the Revenue Act of 1932 and Section 101(6) of the Revenue Act of 1934 (26 U.S.C. §101(6)), both of which read as follows:

> "Sec. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.
>
> The following organizations shall be exempt from taxation under this chapter—
>
> * * * (6) Corporations, and any community chest, fund, or foundation, organized and oper-

ated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation;"

Section 116(d) of the Revenue Acts of 1932 and 1934 (26 U.S.C. §116(d)), which under both acts reads as follows:

"Sec. 116. Exclusions From Gross Income.

* * * * *

(d) Income of States, Municipalities, Etc.—Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the Government of any possession of the United States, or any political subdivision thereof.

Whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility—

(1) If by the terms of such contract the tax imposed by this title is to be paid out of the proceeds from the operation of such public utility, prior to any division of such proceeds between the person and the State, Territory, political sub-

division, or the District of Columbia, and if, but for the imposition of the tax imposed by this title, a part of such proceeds for the taxable year would accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, then a tax upon the net income from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this title, but there shall be refunded to such State, Territory, political subdivision, or the District of Columbia (under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary) an amount which bears the same relation to the amount of the tax as the amount which (but for the imposition of the tax imposed by this title) would have accrued directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, bears to the amount of the net income from the operation of such public utility for such taxable year.

(2) If by the terms of such contract no part of the proceeds from the operation of the public utility for the taxable year would, irrespective of the tax imposed by this title, accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, then the tax upon the net income of such person from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this title."

STATEMENT OF THE CASE

The petitioner, Bear Gulch Water Company, is an operating public utility corporation (R. 40, 42) organized and existing under the laws of the State of California, and during the years 1933 and 1934 was engaged solely in the business of distributing water in the County of San Mateo, State of California (R. 40-42). At all times since 1920 and throughout the two years above mentioned all of its capital stock, bonds and other evidences of indebtedness were owned by the University of California (R. 41, 44).

The University of California is a public trust administered by a corporation known as The Regents of the University of California, which corporation has full powers of organization and government, subject only to such legislative control as may be necessary to insure compliance with the terms of the endowments of the University and the security of its funds (R. 32, 33).

The University of California is a political subdivision of the State of California—in fact, a branch of the State itself—and was organized and exists under and by virtue of the Constitution of the State of California. It is a political subdivision of a state within the meaning of Section 116(d) of the Revenue Act of 1932 (R. 41).

The Regents of the University of California is vested with the legal title and the management and disposition of the property of the University, and all property held for its benefit, and has the power to take

and hold, either by purchase or by donation or gift, testamentary or otherwise, or in any other manner without restriction, all real and personal property for the benefit of the University or incidental to its conduct. All property so held by The Regents of the University of California is held by it in trust for the State of California (R. 33, 42).

Prior to the year 1900 the University of California acquired eighty per cent (80%) of the capital stock of petitioner by gift, and thereafter and prior to the year 1920 said University acquired the remaining twenty per cent (20%) of said capital stock by purchase, and at all times since 1920, including the years 1933 and 1934, The Regents of the University of California owned and held all the stock of petitioner in trust for the State of California (R. 33, 41, 46-47).

By the terms of the gift under which the University acquired eighty per cent (80%) of the stock, the income from such stock was to be used for the maintenance of the College of Commerce at the University of California, and any income received by the University from said stock during the years 1933 and 1934 was, as to eighty per cent (80%) thereof, used for the maintenance of the College of Commerce at the University, and as to the remaining twenty per cent (20%) was to be used for general purposes of the University (R. 41-42).

During the year 1933, although the petitioner had a net income in that year of $50,099.61 (R. 10-12) no dividends were declared by the petitioner on its

capital stock, and hence in that year no dividends were paid to The Regents of the University of California. In the year 1934 the petitioner had a net income of $55,605.36 (R. 12-13) and on October 2nd of that year (R. 45) declared a dividend from its earned surplus (R. 44) in the amount of Ten Thousand Dollars ($10,000), all of which was received by the University of California, the sole stockholder (R. 42, 45).

During the years 1933 and 1934 all of the directors of the petitioner were Regents of the University of California and also members of the Finance Committee of The Regents of the University of California. Petitioner's President and Secretary-Treasurer were, respectively, the Chairman of the Finance Committee of The Regents of the University of California and the Secretary-Treasurer of The Regents of the University of California. The petitioner's directors held their meetings at the same place that the said Finance Committee held its meetings, immediately following each such meeting thereof (R. 34, 43, 45-50).

In 1933 petitioner had a bonded indebtedness of Four Hundred Thousand Dollars ($400,000). In the taxable years in question The Regents of the University of California held in trust for the State of California all bonds and all other evidences of indebtedness of the petitioner (R. 34-35, 44-52), which had been acquired by it at the time of their original issuance.

Based on these facts the petitioner, in its income tax returns for the years 1933 and 1934, respectively,

showed no tax liability for the reason that it excluded from its taxable income, income which it deemed to be subject to exclusion under the provisions of Section 116(d) of the Revenue Act of 1932, as "income derived from any public utility * * * accruing to any state, territory, or the District of Columbia, or any political subdivision of a state or territory * * * ". The Commissioner of Internal Revenue held that the income of the petitioner for the years in question was subject to income tax without any exclusion thereof under the provisions of Section 116(d), and determined deficiencies in the petitioner's federal income taxes for the calendar years 1933 and 1934 in the respective amounts of $6,888.70 and $7,645.74 (R. 40).

The petitioner appealed from the determination of the Commissioner to the United States Board of Tax Appeals and the Board sustained the action of the Commissioner of Internal Revenue in holding that the income of the petitioner for the years in question was subject to tax. However, in rendering its opinion the United States Board of Tax Appeals admitted that there was an ambiguity in Section 116(d) and expressed some doubt as to how it should be interpreted. Petitioner then petitioned the United States Circuit Court of Appeals for the Ninth Circuit to review the decision of the United States Board of Tax Appeals, and in its petition contended that it was also exempt from federal income tax under Sections 103(6) of the Revenue Act of 1932 and of Section 101(6) of the Revenue Act of 1934 (R. 62-63).

The Circuit Court of Appeals affirmed the decision of the United States Board of Tax Appeals (R. 62-68). Its opinion does not, however, embody an interpretation of Section 116(d) resolving the ambiguity asserted by petitioner, and admitted by the Board of Tax Appeals (R. 29) to be contained in said section. Indeed, so far as can be ascertained from the opinion, the ambiguity, if perceived at all, was given no consideration.

THE QUESTIONS PRESENTED.

(1) Was the petitioner a corporation organized and operated exclusively for educational purposes within the meaning of Section 103(6) of the Revenue Act of 1932 and Section 101(6) of the Revenue Act of 1934?

(2) Does the exemption with respect to corporations organized and operated exclusively for educational purposes, as provided in subdivision 6 of Section 103 of the Revenue Act of 1932 and subdivision 6 of Section 101 of the Revenue Act of 1934, apply only to corporations directly operated exclusively for educational purposes and exclude corporations the entire income from which is devoted by another and tax exempt corporation exclusively to educational purposes?

(3) Was the income of petitioner income derived from a public utility and accruing to a state or political subdivision of a state within the meaning of Section 116(d) of the Revenue Acts of 1932 and 1934?

(4) Is not the situation presented by the ownership of all of the outstanding stock of a public utility corporation by a state, or a political subdivision of a state, the only situation to which the first paragraph of Section 116(d) of the Revenue Acts of 1932 and 1934 can have any application, and the only situation which can account for or justify the enactment of said paragraph of said section?

(5) Does not a correct reading of Section 116(d) of the Revenue Acts of 1932 and 1934 require it to be construed as containing two separate and distinct parts, the first part consisting of the first paragraph of the section and applying to the case of a utility which is entirely owned by a state or a political subdivision of a state, and the second part consisting of the remaining paragraphs of the section and applying to the case where a utility is not entirely, or perhaps at all, owned by a state or a political subdivision of a state but an actual or implied contractual relationship exists between the two regarding the acquisition, construction, operation or maintenance of the utility?

(6) Where all the stock of a public utility corporation is owned and held by a tax exempt corporation, viz., The Regents of the University of California, the directors of the public utility corporation are at the same time members of the Board of Regents of the University of California, and every act of the public utility corporation is controlled by The Regents of the University of California, may the existence of such a public utility corporation as an entity separate and apart from The Regents of the University of Cali-

fornia, be disregarded, where failure so to disregard the separate entity of a public utility corporation necessarily results in the imposition of an income tax upon the State of California.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT.

I.

The Circuit Court of Appeals has rendered a decision in conflict with decisions of other Circuit Courts of Appeals on the same subject matter.

(a) The decision below, proceeding upon the findings of the Board of Tax Appeals, that petitioner was organized for the purpose of operating a water distributing system and during the years 1933 and 1934 was engaged in the business of distributing and selling water, and noting that the Board of Tax Appeals did not find that petitioner was organized or operated for any educational purpose, held "that petitioner was not within the exemption of Sections 103(6) and 101(6)." By so holding the Circuit Court failed to recognize the difference between an immediate and an ultimate purpose. Although the immediate purpose of the petitioner was the distribution and sale of water, its ultimate purpose, as an instrumentality of The Regents of the University of California, was to produce an income to be devoted exclusively to educational purposes. The failure of the Circuit Court to recognize this difference between an immediate and an ultimate purpose brings its decision into direct conflict with the decision of the Circuit Court of Appeals for the Sec-

ond Circuit in the case of Roche's Beach, Inc. v. Commissioner of Internal Revenue, 96 F. (2nd) 776.

The facts of the cited case were that the trustees of a charitable trust created by will caused the formation of a corporation to hold and operate trust properties, to pay over to the trustees as the sole stockholders the income, in the form of dividends, derived from the operation of such properties. These properties comprised a bathing beach with the usual incidental activities. The parallel between the cited case and the instant case is apparent. The immediate purpose in the former was the operation of a bathing beach; in the latter, the distribution of water. No part of the net earnings in either case inured to the benefit of any private shareholder or individual. The only purpose and the ultimate purpose sought to be attained in the former case was charitable and in the latter educational, and in both cases the income of the feeding corporation was produced exclusively for the accomplishment of these purposes, respectively. With reference to the taxability of the income of Roche's Beach, Inc., the court said (p. 778),

> "To gain exemption under subdivision 6 of Section 103, 26 U.S.C.A. Sec. 103(6) note, the petitioner must be a corporation 'organized and operated exclusively for . . . charitable . . . purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual.' **This does not mean that to come within the exemption a corporation may not conduct business activities for profit. The des-**

tination of the income is more significant than its source." (Black face emphasis ours).

And further, (pp. 778-779)

> "In our opinion the petitioner is entitled to exemption . . . unless it must be held that this subdivision applies only to a corporation which directly dispenses charity and excludes one which merely produces income for a charity administered by another tax exempt organization. This . . . question . . . is necessarily suggested by the contrast between Sections 6 and 14 . . . . . the implication might arise that no 'feeding' corporation except those there described was intended to be granted exemption . . . But we do not think the implication should be pressed so far. **Exemptions of income devoted to charity are begotten from motives of public policy and are not to be narrowly construed."** (Citing cases.) (Black face emphasis ours).

(b) The decision below declares: "For, although Regents was petitioner's sole stockholder, petitioner's income was not Regents' income and did not accrue to Regents until a dividend payable therefrom was declared by petitioner." The cases cited in support of this declaration will be found on examination not to involve situations arising under the first paragraph of Section 116(d) of the Revenue Acts of 1932 and 1934 where all of the stock of a public utility is owned by a state or political subdivision of a state. On the other hand, the declaration is in direct conflict with the holding of the Circuit Court of Appeals

for the First Circuit in the case of Jamestown & Newport Ferry Co. v. Commissioner of Internal Revenue, 41 F. (2nd) 920, which, although decided prior to the enactment of the statute in its present form, is nevertheless in point as to the meaning to be given the word "accrue" as used in the statute. This case holds, inter alia, and in conflict with the holding of the court below, that income in the hands of a public utility is exempt from federal income tax even though no dividends be paid by the utility to the political subdivision.

II.

The decision of the Circuit Court of Appeals in so far as it relates to Section 116(d) of Revenue Acts of 1932 and 1934 has decided an important question of federal law which has not been, but should be, settled by this court.

The important question of federal law concerns the proper interpretation of Section 116(d) and its sub-sections. The manner in which this section and its various parts have been drawn has made its meaning ambiguous. The opening paragraph of Section 116 reads: "In addition to the income specified in Section 22(b) the following items shall not be included in gross income and shall be exempt from taxation under this title:" Then follow the various items, one of them being (d). It is important to note, however, that (d) is divisible into two main parts, the first, consisting of the first paragraph and apparently applying to a case where a public utility

is entirely owned by a political subdivision, and the second, consisting of the second paragraph and subdivisions (1) and (2), and apparently applying to a case where the utility is not entirely, or perhaps at all, owned by a political subdivision, but where an actual or implied contractual relationship exists between the two regarding the acquisition, construction, operation or maintenance of the utility. The second part in no manner refers to the first part. That the provision for a refund contained in the second part is not applicable to a case where the utility is entirely owned by a political subdivision is demonstrated (1) by the fact that this provision is contained in the second part of the section and not in the first, and (2) by the fact that the refund provided for is to be computed on a pro rata basis which would be wholly meaningless in the case of 100% ownership and consistent only with the theory of less than 100% ownership and a contractual relationship. The only meaning which can logically be given to the first paragraph of subsection (d)—reading it with the opening language of Section 116—is that, in the case of 100% ownership, income derived from any public utility and accruing to any political subdivision is *exempt* from taxation. Either this is true or the first paragraph of subsection (d) is without meaning, and its enactment by Congress cannot be explained.

Neither Congress nor the courts have been able to interpret the section with any reasonable degree of consistency. The various interpretations have in-

creased rather than diminished the ambiguity inherent in the section. Indicative of the confusion of thought regarding this section is: (a) the Finance Committee Report accompanying the Revenue Bill of 1928 (Rept. 960, p. 19) which contains the following statement with reference to Section 116(d): "The section does not relieve the utility from tax. It merely refunds to the state or municipality the amount by which its income was reduced directly because of the tax;" (b) the holding of the United States District Court E.D. Pennsylvania, in 1934 in the case of Philadelphia Rapid Transit Co. v. United States (8 Fed. Supp. p. 152) which announces that the first paragraph of Section 116(d) is "a wholly unnecessary provision since no tax could be constitutionally imposed upon the city . . .;" (c) the decision of the United States Circuit Court of Appeals for the First Circuit in 1930 which holds, inter alia, in Jamestown & Newport Ferry Co. v. Commissioner (41 F. (2nd) 920) that where the political subdivision owned all of the stock of the public utility there was an implied contract and therefore refused or failed to decide the case under what appears to be the clear language of the first paragraph of Section 116(d); (d) the opinion of the United States Board of Tax Appeals in 1939 in the instant case which admits "There appears to be some ambiguity in the manner in which Section 116(d) has been drafted. Does the section mean that in some instances a taxpayer is to exclude part of its income from gross income, so as to make such part exempt from tax; or did Congress intend that the taxpayer

should report its total net income for taxation, and that the State or political subdivision should obtain a refund?" and (e) the opinion of the United States Circuit Court of Appeals for the Ninth Circuit in the instant case upholding the decision of the United States Board of Tax Appeals in this regard. Manifestly, the meaning of the section requires clarification, and until such clarification is provided by this court the above indicated confusion will leave unsettled an important federal question, and the confusion now evident in the lower courts will continue.

It is appropriate at this point to refer to the legislative history of Section 116(d) as an aid in resolving the ambiguity of the section, and it is believed that such reference will support petitioner's view that the section must be construed as containing two parts as above indicated, and that only the first part applies to the situation presented in the instant case.

Section 116(d), in practically its present form, appeared in the original Revenue Act of 1913, and then read as follows:

> "That there shall not be taxed under this Section any income derived from any public utility or from the exercise of any essential governmental function accruing to any State . . . *provided,* that whenever any state . . . has, prior to the passage of this Act, entered in good faith into a contract with any person or corporation, the object of which is to acquire, construct, operate or maintain a public utility, no tax shall be levied

> under the provisions of this Act upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such State . . .; but this provision is not intended to confer upon such person or corporation any financial gain or exemption or to relieve such person or corporation from the payment of a tax as provided for in this Section upon the part or portion of the said income to which such person or corporation shall be entitled under such contract."

The purport of the Section was explained on the floor of the Senate by Senator Shively, of Indiana, who was in charge of the bill during the following debate which is recorded in Volume 50 of the Congressional Record, commencing at page 5320:

> "*Mr. Borah:* Upon page 228 of the bill there is a provision which says:
>
> > 'Provided further, That there shall not be taxed under this section any income derived from any public utility.'
>
> What is a 'public utility'? That would exclude several corporations, some of which are very prevalent here in this District, that I should not want to be excluded under any law.
>
> *Mr. Shively:* Mr. President, in the consideration of this part of the bill there were brought to the attention of the Sub-committee several cases wherein it seemed that there are derived from public utilities and going to municipalities certain incomes that should be exempt. Such income is not derived in the usual course of taxation, and without some provision of this kind it would not

be exempt from the tax. For instance, many years ago there was a public-land grant made by the Federal Government to the State of Illinois. The State of Illinois in turn made a grant from that land to the Illinois Central Railroad Co. The Illinois Central R. R. Co. in consideration of the grant, entered into covenants by which it should perpetually pay into the State Treasury 7% of its gross income. That was one case. Without some provision of this kind that revenue to the State of Illinois might become subject to tax.

"*Mr. Borah:* I understand the force of that argument and the necessity of providing for such a case, but in doing so, has not the provision of the bill gone so far as to exempt, for instance, a gas corporation, or an electric-light corporation, or a telegraph corporation, or a railroad corporation? They are all public utilities.

Mr. Shively: They are all public utilities for the purposes of this exemption in so far as the public acquires a beneficial interest in them. *If the municipality acquires a beneficial interest in their income, this provision will apply; that is to say, suppose it were a lighting utility, and a certain portion of the proceeds were to go to the municipality; to that extent this provision would apply, and the part of the income going to the municipality would be exempt from the tax.*

Mr. Borah: What provision does the Senator from Indiana refer to as a limitation upon the public utility to which it would apply?

Mr. Shively: On page 228 it is provided:

> 'Provided further, That there shall not be taxed under this section any income derived

from any public utility or from the exercise of any essential governmental function——'

Now—mark you—,

'accruing'

That is, income accruing—

'to any State, Territory, or the District of Columbia, or any political subdivision of the State, Territory, or the District of Columbia, or any income accruing to the government of the Philippine Islands or Porto Rico, or any political subdivision of the P. Islands or Porto Rico.'

It seems to me, as the text refers to income and then says 'accruing', that it can exempt only such income as goes to the municipality and can exempt nothing else.

Mr. Borah: Is that the only provision the Senator has reference to as a limitation? It reads:

'Provided further, That there shall not be taxed under this section any income derived from any public utility or from the exercise of any essential governmental function accruing to the state.'

Mr. Shively: Yes, that is true.

Mr. Borah: The word 'or' might make doubtful the construction or the limitation which the Senator puts upon it. I am sure that the committee did not intend to exempt all public utilities.

Mr. Shively: The real facts is that the question presented a good many difficulties. *We did*

not care to appear, so far as the taxing authority could do so, to authorize the State or municipality to go into all kinds of private business and have their income exempted. The words 'essential governmental function' were used as a limitation."
(All italics are ours).

Further light is thrown on the interpretation of the word "accruing" as used in the section by the conference report of Mr. O. W. Underwood to the House of Representatives in connection with certain disagreements between the Senate and the House of Representatives on amendments to the Income Tax Act. The salient part of this report, in so far as it applies to the instant case, appears in the Internal Revenue Bulletin, Cumulative Bulletin 1939-1, part 2, page 7, and reads as follows:

> "The House provision which only exempted profits accruing to the State and their Political Subdivisions from the operation of their essential governmental agencies is modified to the extent that all such profits accruing from public utilities shall also be exempt."

The final explanatory comment of Senator Shively quoted above is highly significant because it can mean but one thing, namely, that Congress did not care to exempt income of states or municipalities except in so far as such income was derived either (1), from the operation of a public utility, or (2), from the exercise of some essential governmental function. It should be noted that these sources of income are expressed in the disjunctive and not in the conjunctive; conse-

quently, normal English usage would dictate that if income from either source accrued to the State of California or a political subdivision thereof, the conditions of the Act had been met.

It is equally as significant that the foregoing debate contains a clear exposition of Congressional intent with respect to the application of the word "accruing". As explained by Senator Shively, "If the municipality acquires a beneficial interest in their income [referring to public utilities], this provision will apply; that is to say, suppose it were a lighting utility, and a certain portion of the proceeds were to go to the municipality; to that extent this provision would apply, and the part of the income going to the municipality would be exempt from the tax." (Portion in brackets ours). And later Senator Shively explains:

> "It seems to me, as the test refers to income and then says 'accruing', that it can exempt only such income as goes to the municipality and can exempt nothing else."

As the language of Section 116(d) has remained practically unchanged since the Revenue Act of 1913, the only evidence of Congressional intent which is pertinent to the present case is the original explanation of Senator Shively. This fact carries great weight, for under the rules of statutory construction, statements by the Chairman of a committee which has charge of a bill are treated as having extraordinary authority.

Hecht v. Malley, 265 U. S. 144; 68 L. Ed. 949.

The above-quoted case also reaffirms the well-established rule that in the interpretation of statutes levying taxes, their provisions are not to be extended by implication beyond the clear import of the language used, and in case of doubt are to be construed most strongly against the government and in favor of the taxpayer.

Senator Shively's explanation gives substance to the argument that as the University of California owned all the stock of petitioner during the years in question, the entire income of petitioner accrued to the State of California and to no one else. As a further indication of the confusion existing with reference to the meaning of the section, it might be asked how the Board of Tax Appeals could arrive at a decision that $10,000 of petitioner's income in 1934 "accrued to the State of California" (R. 28-29) and that "Section 116(d) applies to this $10,000 of petitioner's income" (R. 28-29), and at the same time decide that this income was not exempt from federal income tax.

In this regard the Board of Tax Appeals in its opinion stated (R. 29-30):

> "There remains a question whether petitioner's income to the extent of $10,000 is exempt from tax in 1934, or whether petitioner is taxable on its total net income, and there shall be refunded to the State of California upon its duly filing a claim, 'an amount which bears the same relation to the amount of the tax as the amount which (but for the imposition of the tax imposed

by this title) would have accrued directly to . . . State, bears to the amount of the net income from the operation of such public utility for such taxable year.'

"The quotation above is from subsection (1) of section 116 (d), which follows immediately below the second paragraph of section 116 (d). There appears to be some ambiguity in the manner in which section 116 (d) has been drafted. Does the section mean that in some instances a taxpayer is to exclude part of its income from gross income, so as to make such part exempt from tax; or did Congress intend that the taxpayer should report its total net income for taxation, and that the State or political subdivision should obtain a refund? This question was considered by the Board in the Citizens' Water Co. case. In that case, dividends on preferred and common stock were declared and paid in the taxable years. The city of Burlington owned preferred and common stock of the utility corporation, and, presumably, it actually received the dividends paid on its stock. However, we held that the utility corporation must pay tax on its entire net income. The result was that the city of Burlington would, thereafter, if it saw fit, apply for a refund of the amount of income it lost as an imposition of the tax. . . . The Board's interpretation of section 116 (d) was affirmed, and the court specifically approved the above construction of 116 (d).

"It is concluded that the petitioner is liable for the entire amount of the tax upon its total net income for the year 1934, under section 116 (d)."

Consequently, it would appear that the first paragraph of the section is placed in the Revenue Act for the sole purpose of providing that the income of a public utility accruing to a political subdivision which income might otherwise be subject to taxation in the hands of the public utility would not be subject to taxation to the extent that such income actually accrued to the political subdivision, but that as to such part of such income as the utility was entitled to keep itself, it was subject to taxation. It would then follow that the second paragraph and subdivisions (1) and (2) would apply only in the case where there is a contract between the political subdivision and the utility as distinguished from the case where the utility is wholly owned and controlled by the political subdivision and no contract exists between them.

CONCLUSION.

It is respectfully submitted that the petition for a writ of certiorari should be granted.

Dated: San Francisco, California, July 25, 1941.

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